

Contextual Concentrations

An adaptable framework for evolving markets





SS&C ALPS Advisors
is an open architecture
boutique investment
manager offering portfolio
building blocks, active
insight and an unwavering
drive to guide clients to
investment outcomes
across sustainable income,
thematic and alternative
growth strategies.



Summary and Key Takeaways

Traditional portfolio construction does not map to reality

- Backward-looking and optimized to the past
- Does not consider adaptations in the market, creating an improper assessment of risk
- Is alpha diminishing as most funds target the same metrics

The Contextual Concentrations framework takes a unique approach to portfolio construction based on the continuous adaptability of markets

- Forward-looking and constructed for the continuously evolving market environments
- Properly accounts for risk by adjusting to market dynamics
- Understands momentums, changing correlations and pervasive macro environment for investing contexts
- A reality-based approach for differentiated returns

Dilemma: The Map Does Not Resemble Reality

The most popular forms of portfolio construction rely on backward-looking relationships and standardized groupings of securities, which can fail to appreciate the dynamism inherent in markets. As a result, risk is categorized by over/under weighting sectors or factors and determining active positioning relative to these generic segments of the investible universe.

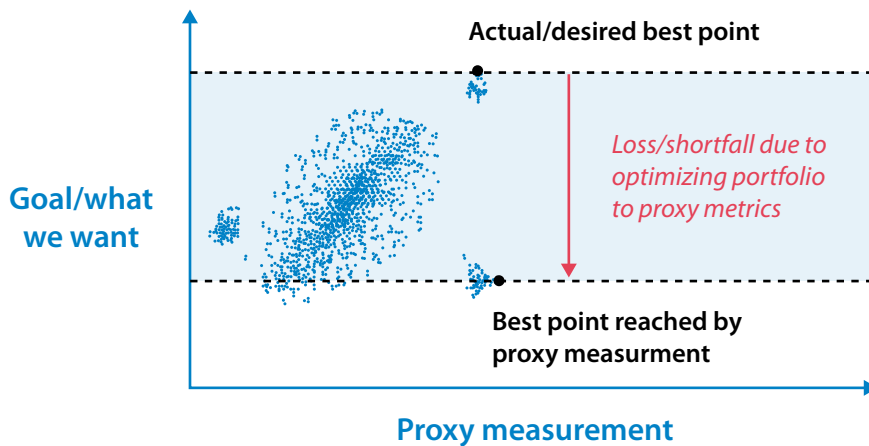
The oversimplifications embedded in these techniques diminishes their effectiveness in forecasting the continuous structural evolution of the market. Correlations change, styles drift and companies adapt. This dynamism is exactly what allows for the existence of alpha.

Alpha is used in finance as a measure of performance, indicating when a strategy, trader, or portfolio manager has managed to beat the market return over some period.

We hypothesize that the average active manager has underperformed their benchmark largely because they've reduced their flexibility to interact with this dynamism - their portfolio utilizes standardized metrics to maximize an outcome, but is only capable of maximizing the metrics at a point in time that has already passed. And so the measure becomes the target and the use of targets fails.



Goodhart's Law



When a measure becomes a target, it ceases to be a good measure.

Charles Goodhart,
British Economist

Goodhart's Law originated from a paper authored by economist Charles Goodhart in 1975, and became well known in the 1980s as an explanation for why the British Government's attempt to control inflation through the use of monetary targets failed. Historically there had been a high correlation between money supply and inflation. So Chancellor Nigel Lawson decided to publicly set targets for money supply growth in order to control inflation. But when the "measure" became a "target" the relationship broke down.

The role of active management is to provide outperformance in excess of fees*

Goodhart's Law largely explains the current condition and predicament of the active management industry. Unfortunately, the vast majority of active funds can be replicated with a mixture of low cost beta exchange-traded funds (ETFs), and therefore have struggled to carry their weight of fees in investor portfolios. We believe that this occurrence largely manifests from the tendency of managers to view investment opportunities through a common framework of security classifications and highly available financial ratios. Almost by definition, active managers will struggle to produce unique excess returns while positioned in such ubiquity.

** Ordinary brokerage fees apply.*

We believe that Goodhart's Law presents two guiding principles for active managers:

1

Consider the relationship between cause and effect, and do not assume that maintaining a particular metric or classification technique will deliver success.

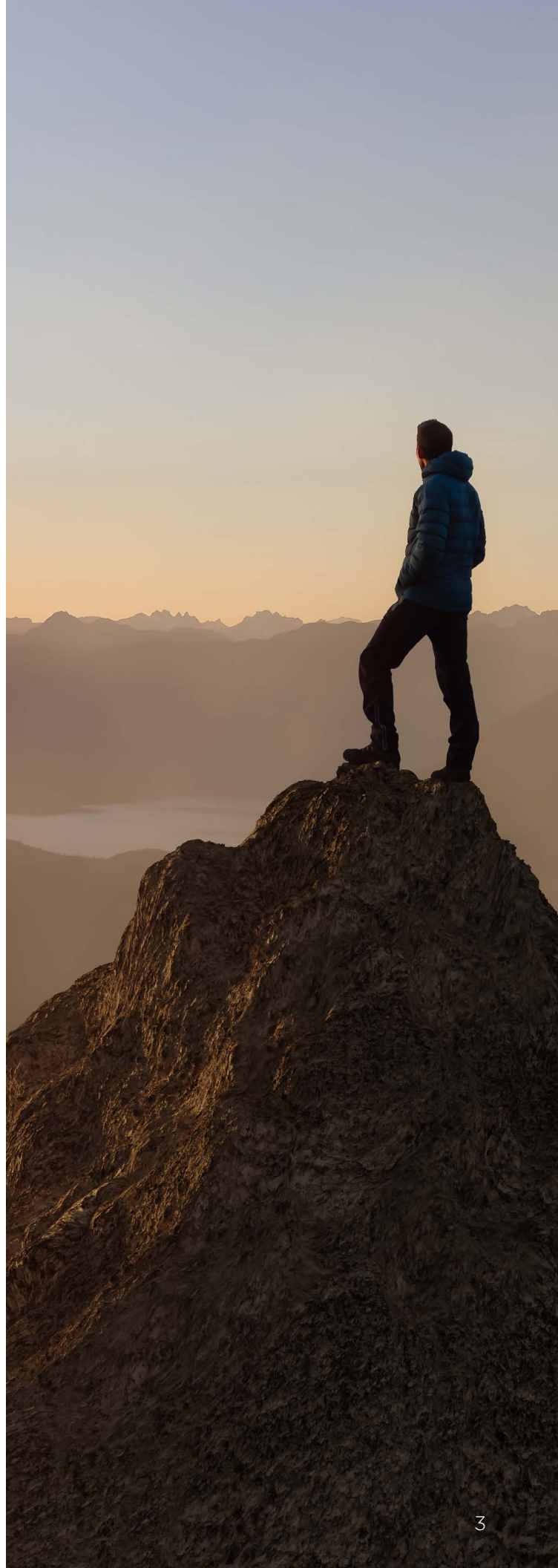
2

An active manager will only generate exceptional returns for investors if what they do is different.

Solution: The Contextual Concentrations Framework

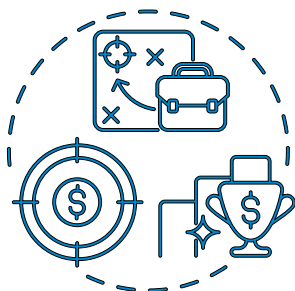
The core tenet of SS&C ALPS Advisors' Contextual Concentrations framework is the continuous adaptability inherent in markets and other complex systems. This method allows for a **flexible** and **forward-looking** approach to modeling market and portfolio risk by embedding fundamental analysis within the "story-driven" contexts which naturally drive markets. The framework aims to understand the context in which momentum is concentrating, identify the basic currents driving these movements and catalog the persistence of each development. Once a proper assessment of the ebbs and flows of the market are appreciated, risk can be rationally calibrated and fundamental analysis becomes much more powerful.

The Contextual Concentrations framework offers the potential for better risk-adjusted returns by adapting to the current market environment instead of optimizing to the past.



Contextual Concentrations: Recognizing Drivers of Future Market Momentum

In order to demonstrate the power of Contextual Concentrations, let's take an extreme example of the COVID-19 market meltdown through two lenses:

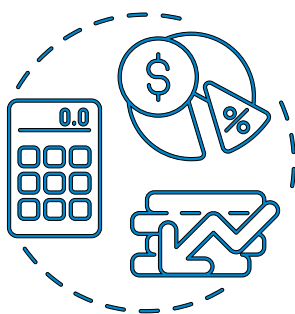


INNOVATIVE

Portfolio construction using the Contextual Concentrations framework

Through the prism of the Contextual Concentrations framework, the investor understands the instability of traditional metrics from the outset and is not surprised by their lack of protection during a powerful market shock. Additionally, the investor understands this powerful shock as a regime change, and to begin searching for **new contexts that will be driving future momentum in the marketplace**. In this instance, some of the most powerful contexts were “work from home,” “interest rate sensitivity” and “the resiliency of technology.”

VS.



TRADITIONAL

Portfolio construction relying on backward-looking return relationships

Prior to the drawdown, a portfolio perfectly constructed to maximize risk and return within a traditional framework **would add little value** as correlations began to synchronize. Similarly, coming out of the drawdown, these backward-looking metrics would prove just as futile as they had no capacity to comprehend the tailwinds that were forming. We all understand that to employ these traditional frameworks we must disregard or work around these types of glaring inconsistencies.

Having recognized the instability of markets, Contextual Concentrations attempts to understand the tailwinds driving returns by studying emergent momentums and correlations. We begin by categorizing momentum and understanding directional trends.

Types of Momentum

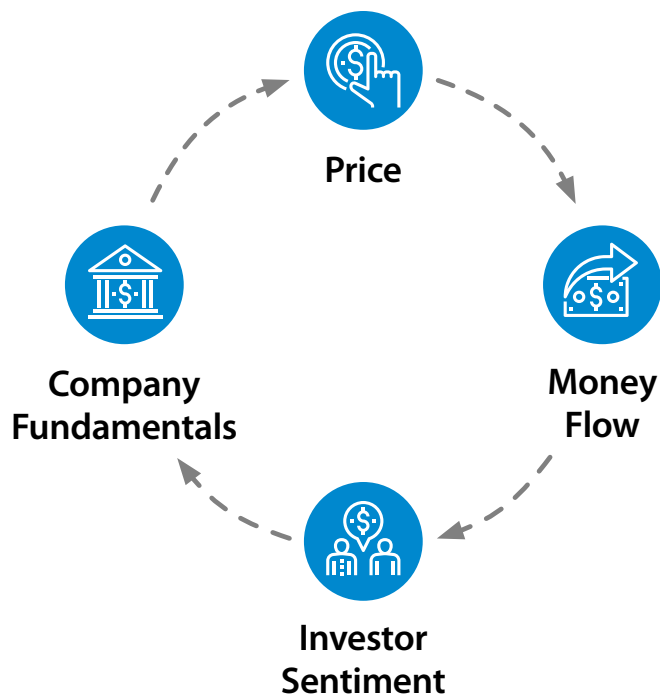


Three Key Aspects of Momentum

- 1 | Each type of momentum can occur in isolation, but ultimately has the potential to influence the others.
- 2 | Momentum can act on individual stocks or on a group of stocks with commonly prized features.
- 3 | Most significantly, when these momentums occur in conjunction they have the potential to amplify and reinforce each other, creating a powerful feedback loop.

Traditional approaches view momentum through price only, which is the basis of trend-following strategies. This approach captures the end result without understanding the underlying drivers. **By viewing each momentum independently as well as collectively, we can create better understanding of the emergent behaviors driving market movements.**

A Reinforcing Momentum Feedback Loop



Momentums that occur in conjunction have the potential to amplify and reinforce each other, creating a powerful feedback loop.

The Contextual Concentrations framework seeks to measure momentums and their directions in order to craft a better roadmap of the future.

Case Study: Investor Sentiment-Driven Momentum and Tesla

While it is easy to imagine improving fundamentals driving changes in momentum, let's consider a less common occurrence: investor sentiment facilitating improving fundamentals. For example, the momentum building behind Tesla beginning in the latter half of 2019.

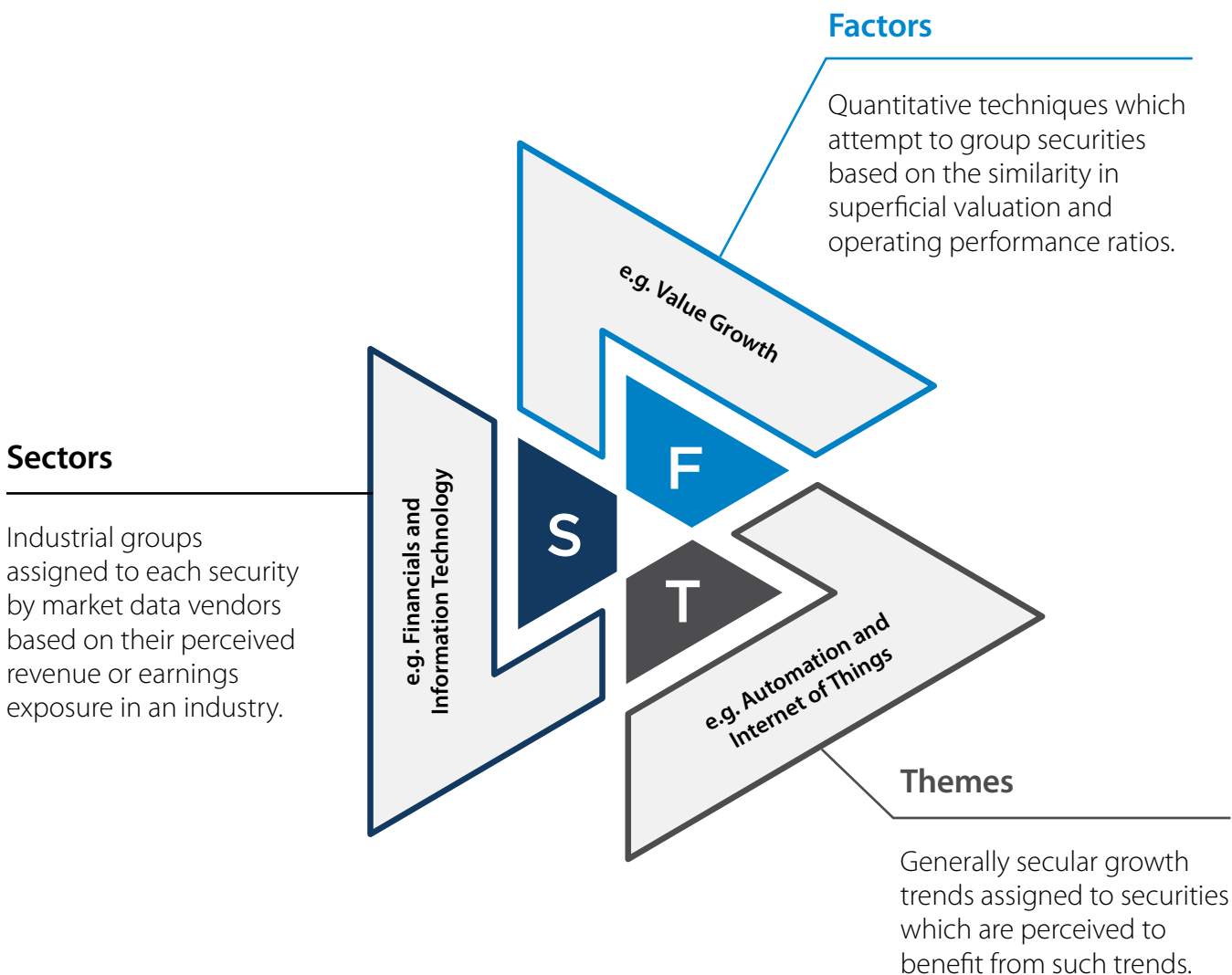
In this instance, investor sentiment overcame poor company fundamentals and catalyzed and influenced the other components in a powerful positive feedback loop. Tesla continuously hit all-time highs as investor sentiment produced positive inflows and allowed the company to issue equity, improve fundamentals by investing in projects at a lower cost of capital, avoid possible bankruptcy and become a formidable auto manufacturer.

Understanding past and current momentum trends can create a better capacity for remaining adaptable and flexible within continuously evolving market environments.

Contextual Concentrations: The Attribution of Momentum

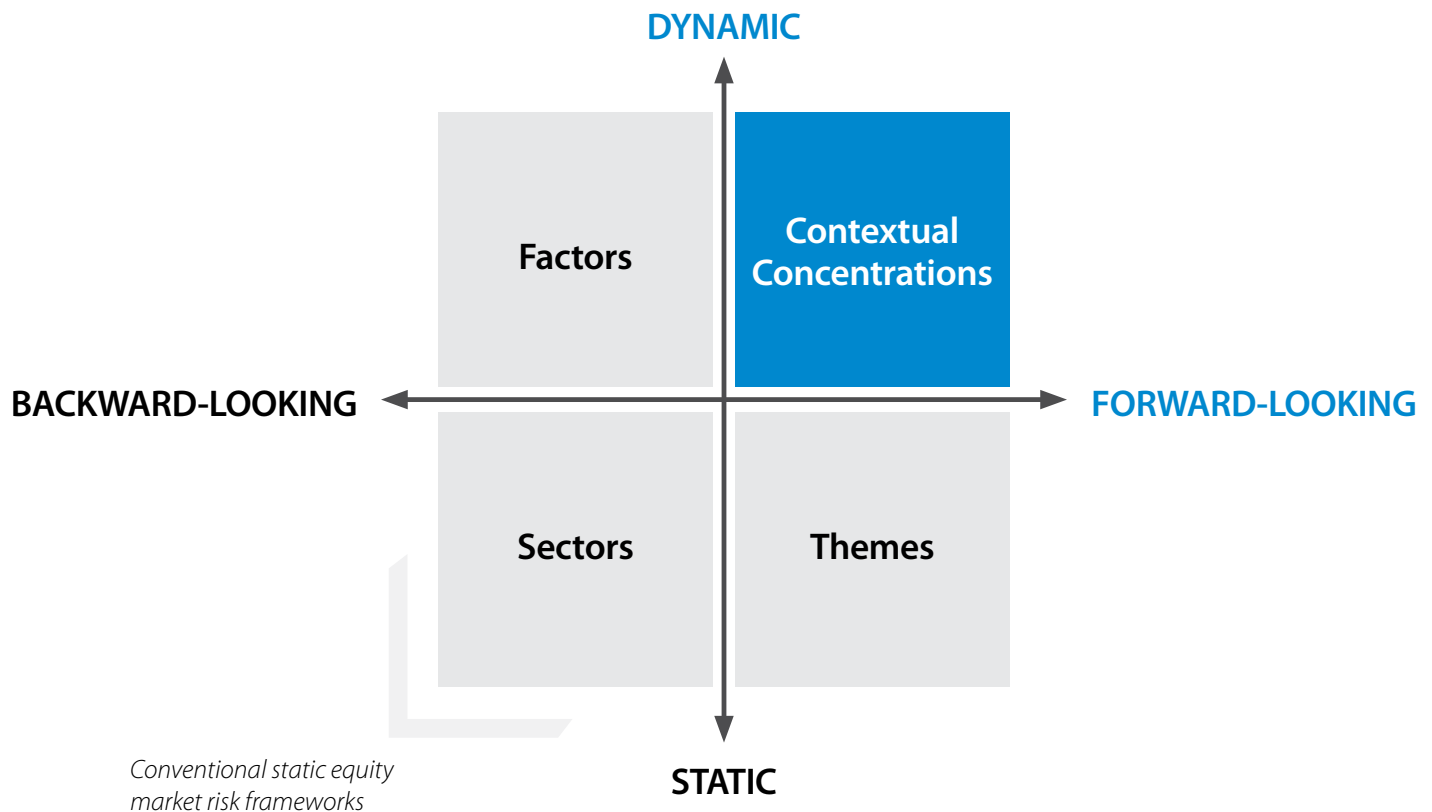
In conjunction with identifying the reflexive feedback loop of fundamentals, sentiment and market momentum, an additional task in defining Contextual Concentrations is the attribution of that momentum, or **the process of identifying momentum's origins and drivers**.

Perhaps the best way to explain the attribution of momentum is to compare Contextual Concentrations to the conventional static equity market risk frameworks used to evaluate market risk: sectors, factors and themes.



These frameworks, sometimes referred to as sector, style and theme “**betas**”, are used by market participants to disaggregate market risk into different components, with the intention of calculating a portfolio’s exposures to these components to measure and manage portfolio risk.

Contextual Concentrations studies the “**emergent betas**” that originate from the interaction of momentums occurring across any combination of sectors, factors and themes. This process results in a unique perception of the way securities are grouped and market risk is disaggregated, offering the active manager a differentiated framework to generate alpha and manage portfolio risk.



Case Study: The FAANG Phenomenon

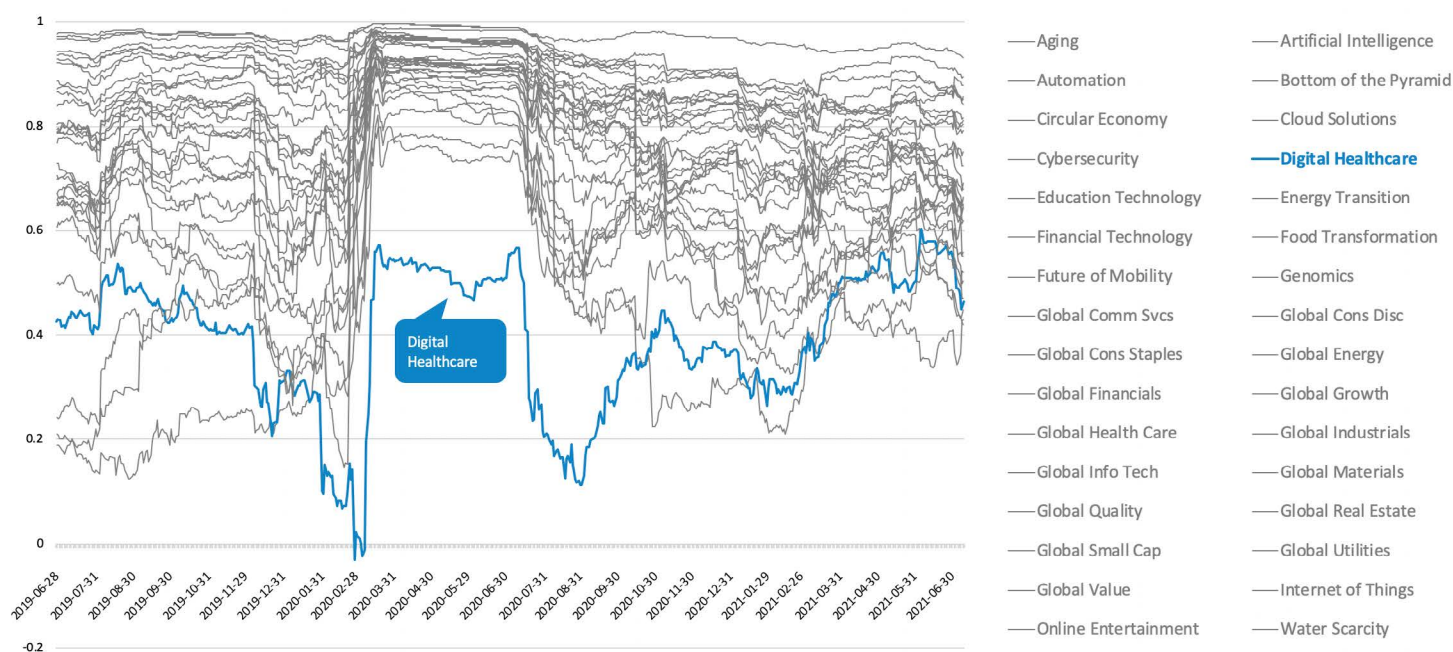
Facebook, Amazon, Apple, Netflix and Google rose to dominance in their industries over the latter part of the last decade as investors flocked to the so-called FAANG stocks. Although the simultaneous momentum in the advancement of web services, mobile internet usage and consumer data collection were driving the business of all five companies, they weren't all classified as Information Technology stocks in standard risk models. Performing advanced clustering analysis of these stocks' returns throughout 2017 would demonstrate that their returns had become increasingly correlated over time.

While a traditional risk model might have allocated to all FAANG stocks based on their sector categorization split across different sectors, the FAANG Contextual Concentration process would observe these stocks as more related, allowing for a more realistic allocation of risk in the portfolio.

Contextual Concentrations: What is Driving Performance Patterns?

The process of observing the changes in the correlation of momentum is merely an initial step. After discovering stock clusters with similar behavior, the Contextual Concentrations framework seeks an interpretation: what is driving the performance patterns? The deductive process of reasoning that momentum correlation among securities may be caused by an investible commonality, followed by the inductive process of examining the specifics of correlated companies to draw a general conclusion regarding that commonality, is central to the process of identifying Contextual Concentrations. Once the fundamental momentum of the context is researched and validated, it can be arbitrated based on its expected persistence, indicating a possible strategic or tactical allocation in the portfolio. Lastly, underlying this entire process is the principle that most of these relationships are impermanent, regardless of persistence, and to remain vigilant for the inevitable breakdowns.

Sector, Factor & Themes 90-Day Rolling Correlations to Market Around COVID-19 Financial Markets Shock



Source: Bloomberg, as of July 9, 2021

The chart above illustrates, during the initial period of COVID-19, that “Digital Healthcare” stocks separated from the other monitored stocks, indicating a potential context for investing that demanded more studying.



Assembling a “Theory of Evolution” for Adaptive Markets

The underlying philosophy driving the Contextual Concentrations framework is the universal application of Charles Darwin’s Theory of Evolution. The market is a complex adaptive system in which the interaction and competition of unique and diverse agents drives the continual progress and changing environment of the entire system. As such, certain environments reward participants with relative fitness for that specific moment. Furthermore, the most adaptable and resilient agents are equipped for a broader range of environments.

By leveraging widely available tools and filtering decision making through the unique lens of Contextual Concentrations, we can potentially create better tactical and strategic decisions as well as better understand the real risks underlying portfolio construction.

Conclusion

The benefit of Contextual Concentrations to the end investor is an opportunity for outperformance. This is due to the fact that there are two requirements to outperforming in active management:

- 1 | taking a different view from consensus, and
- 2 | managing that view effectively.

By restructuring the classification of risk and reward opportunities in the investable universe away from the standard framework used by most asset allocators, index trackers and active managers, investors using Contextual Concentrations are constantly challenged and encouraged to take a view that differs from consensus.

We believe this simple adjustment of looking at the world differently than others offers an opportunity to capture excess returns for our investors.

Interested in seeing our Contextual Concentrations framework in action?

The **ALPS | Smith Balanced Opportunity Fund** invests in both equities and fixed income securities and seeks to provide capital growth and income for investors. The Fund's equity sleeve uses the flexible and dynamic Contextual Concentrations framework to position the portfolio for market conditions, risk factors, and outlook.

Investment Objective: The Fund seeks long-term capital growth, consistent with preservation of capital and balanced by current income.

Learn more at **alpsfunds.com**

Top 10 Holdings

ALPS | Smith Balanced Opportunity Fund

| | | | |
|------------------|-------|--|-------|
| Apple, Inc. | 4.23% | JPMorgan Chase & Co. | 2.16% |
| NVIDIA Corp. | 3.71% | Taiwan Semiconductor Manufacturing Co., Ltd. | 1.66% |
| Microsoft Corp. | 3.04% | U.S. Treasury Bond 4.50% 02/15/2044 | 1.65% |
| Amazon.com, Inc. | 2.51% | U.S. Treasury Bond 4.625% 05/15/2044 | 1.59% |
| Alphabet, Inc. | 2.20% | U.S. Treasury Bond 4.25% 02/15/2054 | 1.53% |

Source: Bloomberg L.P., as of 6/30/2024, subject to change

Definitions

Active Management: implies that a professional money manager or a team of professionals is tracking the performance of an investment portfolio and regularly making buy, hold, and sell decisions about the assets in it. The goal of the active manager is to outperform the overall market.

Alpha: a measure of performance on a risk-adjusted basis; often considered the active return on an investment, the ratio gauges the performance of an investment against a market index used as a benchmark.

Beta: a measure of the volatility, or systematic risk, of a security or a portfolio in comparison to the market or a benchmark. The beta of the market or benchmark is 1.00 by definition. An investment with a beta above 1 is more volatile than the overall market, while an investment with a beta below 1 is less volatile.

Correlation: a statistic that measures the degree to which two variables move in relation to each other.

Disaggregate: the process of breaking down information or data into smaller sub-categories.

Emergent Beta: the correlation that arises between otherwise unrelated stocks due to the unique interactions and characteristics of the market environment.

Financial Ratio: a relative magnitude of two selected numerical values taken from a company's financial statements. Financial ratios are used in ratio analysis, which is a quantitative method of gaining insight into a company's liquidity, operational efficiency, and profitability.

Growth: as it relates to investing, an investment style and strategy that is focused on increasing an investor's capital.

Tailwind: a certain situation or condition that may lead to higher profits, revenue or growth.

Value: the monetary, material, or assessed worth of an asset, good or service.

Important Disclosures

An investor should consider the investment objectives, risks, charges and expenses carefully before investing. To obtain a prospectus containing this and other information, call 1-866-759-5679 or visit www.alpsfunds.com. Read the prospectus carefully before investing.

Performance data quoted represents past performance. Past performance is no guarantee of future results; current performance may be higher or lower than performance quoted.

All investments are subject to risks, including the loss of money and the possible loss of the entire principal amount invested. Additional information regarding the risks of this investment is available in the prospectus.

A rise in interest rates typically causes bond prices to fall. The longer the duration of the bonds held by a fund, the more sensitive it will likely be to interest rate fluctuations.

The Fund's investments in fixed-income securities and positions in fixed-income derivatives may decline in value because of changes in interest rates. As nominal interest rates rise, the value of fixed-income

securities and any long positions in fixed-income derivatives held by the Fund are likely to decrease, whereas the value of its short positions in fixed-income derivatives is likely to increase.

Overall securities market risks may affect the value of individual instruments in which the Fund invests. Factors such as domestic and foreign economic growth and market conditions, interest rate levels, and political events affect the securities and derivatives markets. When the value of the Fund's investments goes down, your investment in the Fund decreases in value and you could lose money.

ALPS Advisors, Inc. and Smith Capital Investors, LLC, registered investment advisers with the SEC, are the investment adviser and sub-adviser to the Fund, respectively. ALPS Advisors, Inc. and ALPS Portfolio Solutions Distributor, Inc., affiliated entities, are unaffiliated with Smith Capital Investors, LLC.

ALPS Portfolio Solutions Distributor, Inc. is the distributor for the Fund.

Not FDIC Insured • No Bank Guarantee • May Lose Value

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